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C O N F I D E N T I A L SECTION 01 OF 04 TOKYO 000894

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TAGS: EFIN ETRD PREL JA
SUBJECT: POSTAL PRIVATIZATION: FOLLOWING THE MONEY

Classified By: Ambassador J. Thomas Schieffer for reasons 1.4 b/d.

Summary

¶1. (C) Japan Post,s to-be-privatized insurance and banking entities need to focus on risk management and their asset/liability term mismatch (as much or more than they are focusing on new products) if they are to have a successful initial public offering (IPO). This was the principal conclusion to emerge from discussions with financial experts over several months. Other common themes were that the privatization of Japan Post was so large that a worst-case failure could have dramatic effects on the Japanese economy, and that, as of now, the draft succession plan of Japan Post was too vague to instill investor confidence. One expert maintained that the financial entities' switch from government to private assets would be slow and not lead to a jump in overall stock prices, because most deposits were of fixed term and would become available only after several years. Another noted the great effect revenue from IPOs could have on the government's debt, perhaps a reason why PM Abe recently urged that the IPOs be held sooner rather than later. None of the experts would venture to say what price the entities' shares would fetch, although several explained what the market would be looking for in its evaluation. End summary.

Intoduction

¶2. (U) Under the postal privatization law passed in October 2005, Japan Post -- a public corporation that combines mail service, banking, and insurance -- will be split into six companies on October 1, 2007: the Japan Post (JP) Corporation (a holding company separate from Japan Post); new insurance, banking, delivery, and postal entities; and a "Successor Corporation" to hold pre-existing, government-insured savings deposits and insurance. Within the following ten years, the holding company will sell off its stock of the insurance and banking entities, leading to full privatization. JP Corporation originally suggested that the initial public offering of the banking and insurance entities' stocks would take place in 2011; recently, however, the possibility of an IPO in 2009 has been floated.

¶3. (SBU) To complement Embassy advocacy and reporting on the

competition aspects of postal privatization, ECOUNS initiated a series of information gathering sessions on the privatization process's likely financial effects. This report is based on discussions with the following researchers and experts, all of whom have written about Japan Post privatization:

Robert Feldman, Managing Director, Morgan Stanley, Japan
Kathy Matsui, Managing Director and Chief Japan Strategist, Goldman Sachs
Takashi Miwa, Senior Economist, Nomura Securities
Naoyuki Yoshino, Director, Financial Services Agency (FSA) Financial Research and Training Center
Matoko Kasai, Vice President, Equity Research, NikkoCitigroup
Kazuhiko Toyama, COO, Industrial Revitalization Corporation of Japan (IRCJ) and member of Postal Services Privatization Committee (PSPC)

¶4. (C) JP Corporation,s Draft Succession Plan states that when the privatization commences on October 1, 2007, its new life insurance entity (Kampo) will have assets of 114,589 trillion yen (about $954 billion at 120 yen to the dollar) and liabilities of 113,589 trillion yen ($946 billion), while the banking entity (Yucho) will have assets of 226,991 trillion yen ($1.89 trillion) and liabilities of 220,191 trillion yen ($1.83 trillion). Posed the questions of what lay behind these numbers, how the entities will be positioned for initial public offerings, and the main challenges the entities will face in the interim, the experts all began their analysis from core principles contained in the privatization legislation. Their discussions of implementation quickly and significantly diverged, however, as they acknowledged that important operational details remain murky. Nonetheless, several common themes emerged.

Coming Challenges: Risk Management and IPOs

¶5. (C) Foremost among their concerns was the postal savings and insurance arms' lack of risk-management experience and expertise. Given that the postal institutions have offered products (often short-term) with government guarantees and invested assets in long-term Japanese government bonds (JGBs), as well as similarly low-risk GOJ "second budget" Fiscal Investment and Loan Program (FILP) bonds, expansion into competitive operations will expose their poorly matched asset and liability structure. Hedging against the asset-liability mismatch and not misjudging the risks inherent in new products will be two of the entities' biggest challenges.

¶6. (C) The stakes are high for developing or acquiring sufficient risk management expertise. As Toyama pointed out, a failure of the to-be-privatized entities would be "the largest in human history," with effects that could reach the level of "systemic risk" and even spill into international financial markets. More narrowly focused on the effects of the institutions' IPOs on the stock market, Matsui added that a poorly timed offering could depress Japan's banking sector, or, in the worst-case scenario, a not-yet-ready-for-privatization Japan Post IPO could weigh down the whole Japanese market.

¶7. (C) Regarding the IPOs, analysts noted that although Japan Post Corporation released a "draft implementation framework" in July 2006, containing planning for the operational transition of the new financial entities, no accompanying business plan upon which investors would stake their money had been released. One called business planning to date "unsatisfactory;" another ventured to say that, in the apparent absence of a business model, no broker or buyer would proceed with an IPO at this stage. A business plan is needed, they explained, to specify in more detail expected products, risks, interest rate spreads and rates of return. The analysts also lamented a lack of public detail about the

insurance entity's re-insurance contract with the Postal Successor Corporation, which will likely be the largest liability ever accepted by a corporate organization. One analyst noted that moving away from government bonds would increase the need for real capital reserves, and the plan needed to explain how that would be achieved.

¶8. (C) Analysts differed on how best to address the banking and postal entities' business challenges, but they agreed their most valuable assets included access to the post office network as a distribution channel and the new insurance entity's re-insurance contract. Several suggested ways the new entities could build new business around the strength of the distribution network, for example by concentrating on sales of financial products instead of their "manufacture," perhaps even by selling third-party products for a fee. (Note: Japan Post is already distributing investment trusts of private financial companies through the post office network.)

Money Flows: How Much? Where to?

¶9. (C) Regarding the potential value of the IPO, experts referenced basic financial theory in that the entities' price will depend on investors' perception of the future income stream inherent in the physical and business entities at the time of the IPO (hence the cited need for more information about the business plan). A major factor affecting that income stream will be what kind of products the entities plan to offer and how well they deal with acquiring new expertise to develop products and garner market share. For the insurance entity, Kasai pointed out that the "embedded value" of current policies would be factored into the price alongside potential future income.

¶10. (C) Another factor affecting overall valuation will be the mechanics of how JP Corporation offers shares to the market. Recalling past privatizations, Matsui noted that a common problem is that the enterprises offered are so large

that their stock must be sold in progressive phases. Wishing to maximize revenue, governments tend to sell a tranche of stock each time the price moves up, thereby capping the stock's upward movement and preventing a fuller valuation that would come over time.

¶11. (C) In any case, the proceeds of the sale will eventually flow to the Japanese government, because the holding company, JP Corporation, will be 100% government-owned at the time of the IPO. Feldman stated that this could be viewed as the financial entities "paying" for the physical and business assets they receive in privatization. He proffered that the government would divert some of the money to the Social Responsibility Fund created by the privatization law, and could use the rest to pay down its debt. (Comment: This could be a reason why PM Abe recently called for the IPOs to be made sooner rather than later.)

Individual Insights

¶12. (C) Based on individual research, experts offered a number of one-off insights into the privatization process:

-- Feldman noted that some of the postal bank's holdings are in municipal bonds, some of which are likely to default. The government will have to work out who bears the cost of such defaults after privatization. He also noted that the postal insurance entity may not need an IPO, because it currently has a surplus of capital (its solvency ratio has been estimated around 1300% versus most private sector companies' 400-600%). Thus, if it can find a mechanism to change its policy-holders into stockholders, an IPO would be unnecessary.

-- Matsui discounted initial speculation that privatization

might have a dramatic effect on stock prices as postal bank savings moved into equities. Goldman Sachs's research indicated that effects on the stock market, at least in the medium term, were expected to be gradual because 74% of postal savings are currently in the form of term deposits. Only as those deposits come to maturity (the largest block matures between 2010 and 2012) will they be available for other investment instruments.

-- Miwa's model suggested three major changes to financial flows in the Japanese economy: 1) the overall flow of funds into the postal entities will decrease, because they will no longer offer a government guarantee; 2) the composition of funds flowing out of the entities will change, with the most significant shift being the reduction of funds to the FILP from a current 200 trillion yen to around 10 trillion in FY2017; and 3) simultaneously, postal banking and insurance entities would begin to hold securitized commercial and household loans, as well as increasing their holdings of JGBs. He attributed the increase in JGBs to the continued need to hold conservative assets against remaining government guaranteed liabilities.

-- Yoshino pointed out that the difficulties of privatization include regional cost differences and a rapid decline in postal savings. He attributed the decline in savings to the rise of ATM networks and convenience store banking, which have blunted the post office's convenience advantage -- its most important attractor of customers.

-- Toyama maintained that the new entities' size in some cases will hinder them. Pointing out that current postal bank holdings are almost entirely JGBs, he noted the interest rate risk it will have to try to hedge against and asked, "Who is going to take the other side of a 200 trillion yen swap?" Quality of service is also crucial, he said, adding that past problems in Japanese markets showed that larger companies were not necessarily better at managing people's assets.

-- Asked about cross-subsidization, Toyama considered that none of the new companies would be in a position to financially help the others, and if they tried to they would likely "kill business discipline" (i.e. efficiency). JP

Corporation's top managers, he posited, were smart enough to know that and avoid cross-subsidization in their own interest.

Comment

¶13. (C) While the experts had some common concerns and all worked from the principles established by the postal privatization laws, their understanding of privatization mechanisms -- and hence their analysis -- differed substantially. Those differences extended even into relatively large components of the process, such as the re-insurance relationship between the new postal insurance entity and the successor corporation handling the old company's government-guaranteed policies. Seven months prior to the world's largest financial institution starting a ten-year privatization process, significant operational details of the transition remain elusive even to the experts.
SCHIEFFER